This paper reviews the legal requirements governing the splitting of the US pension plan assets, in conjunction with a corporate sale or spinoff.

Although ERISA and the lateral Revenue Code contain guidelines, the ultimate amount of assets will depend upon the assumptions employed by the actuary in determining the present value of the benefits.

The paper provides the wide range of outcomes which can occur. It also identifies certain fact-patterns which can create complications.
Many business divestitures or acquisitions involve the transfer of employees from the seller's pension plan to a plan sponsored by the buyer. When pension liabilities and plan assets are transferred ("spinoff" is the technical term), the basis for determining the amount of the assets can be the most bitterly contested section of the sale agreement. Unfortunately, the negotiating teams may be unaware of the effect of legal restrictions on the transfer amount, and the final calculations could topple the most carefully crafted compromise.

ERISA and the Internal Revenue Code (the "Code") provide only theoretical guidelines; it is the actuary for the seller's plan who renders the ultimate opinion that the transfer complies with the law and the Code. The tools for enlarging or shrinking an asset transfer are the actuarial assumptions, the selection of which requires expertise in spinoffs, discretion and (with caution) advocacy.

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(1) Sometimes the seller's plan remains responsible for benefits earned thereunder, using an approach called "lock and freeze." The buyer can establish a plan (or not) and can base benefits on future service or a total employment. Since neither liabilities nor assets are transferred, no spinoff is involved.

(2) This assertion is contained in the Actuarial Statement required to be filed with IRS Notice 5310-A prior to the spinoff. Note that the actuary for the receiving plan has neither a right nor an obligation to concur in this opinion. (A receiving actuary's duty is to evaluate how the merged plan stands on a termination basis, after combining the two asset funds. A "special schedule" must be constructed if the combined assets do not fully fund the combined benefits of the merged plan.)
Legal Requirements

Pension plan spinoffs are governed by Sections 208 of ERISA and 414(\ell) of the Code.\(^{(3)}\) These require the participants in both the spinoff group and the remaining group to be as protected if the plan would terminate immediately after the spinoff as they would have been if the plan had terminated immediately prior to the spinoff. This means that if the original plan is fully funded on a termination basis, both segments must remain fully funded after the spinoff. Surplus assets can be allocated with total discretion, subject to any special restrictions in the Plan document.

The plan sponsor's and actuary's quandary is to ascertain what level of assets would fully fund the hypothetical plan termination. A financial executive might expect that the ABO under SFAS #87 (Accumulated Benefit Obligation, roughly equivalent to the value of Accrued Benefits) would be an appropriate amount. An ERISA attorney might believe that regulations under IRC 414(\ell) contain the answer. However, a literal following of either of these rules could not only be wrong but costly. An intended asset transfer of $20 million can readily become $12 million or $26 million, depending on the actuarial assumptions.

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\(^{(3)}\) Section ERISA 208 provides as follows: "A pension plan may not merge or consolidate with, or transfer its assets or liabilities to, any other plan after the date of the enactment of this Act [enacted Sept. 2, 1974], unless each participant in the plan would (if the plan then terminated) receive a benefit immediately after the merger, consolidation, or transfer which is equal to or greater than the benefit he would have been entitled to receive immediately before the merger, consolidation, or transfer (if the plan had then terminated)." Section 414(\ell) of the Code contains similar language and also provides rules for splitting a plan surplus (which rules apply only to spinoffs within a controlled group and, as stated above, do not affect the situation considered here).
The Situation

This article will suggest some guidance on how far the seller's actuary can go in the selection of assumptions which are both legal and financially favorable. I shall assume a seller who is the sponsor of a well-funded Plan having $100 million of assets, generous early retirement subsidies, and covering a primarily non-retired group. 20% of the participants (representing an identical demographic slice of the entire Plan) are being transferred to the Plan of an independent buyer. What is the minimum amount of assets which can be spunoff? What is the maximum?

The objective is to simulate a plan termination. The first step, then, is to ascertain what benefits would be paid by the Plan upon termination (omitting any additional benefits provided by the PBGC). There is general understanding that all of the following would be included: accrued benefits as of the spinoff date; all early retirement subsidies; annuity forms; other rights and features attached to these benefits\(^{(4)}\). Other benefits, such as death or disability features and subsidies which might become payable due to a future plant shutdown, can create tremendous additional liabilities. These benefits can, however, be amended out of the plan prior to a future termination. But, unless they have already been removed prior to the spinoff, it may be difficult to ignore them in the spinoff calculations.

Let us assume, however, that the opposing parties have no dispute on this aspect of the spinoff.

\(^{(4)}\) These benefits are described in Code Section 411(d)(6) and regulations thereunder, in Revenue Rulings 85-6 and 86-48, in PBGC policies and procedures, and in various court decisions.
The Role of Actuarial Assumptions

The minimum asset transfer which can be considered "bullet-proof" is the amount a sufficiently-solvent insurance company would charge to annuitize the spinoff benefits. This is because an annuity purchase would be required if the plan would indeed terminate. (Both participating and nonparticipating annuities have been known to be acceptable to PBGC.) However, neither plan sponsor nor annuity carriers must undergo this shopping expedition, because the regulations under IRC 414(f) permit the plan's actuary to step into the shoes of an annuity carrier and to estimate what its cost might be.

The actuary does so by the selection of appropriate actuarial assumptions regarding:

- Mortality (i.e., lifespan)
- Retirement Age
- Interest Discount
- Rates of employee turnover and/or disability

These same types of assumptions are used for determining IRS minimum funding requirements and for FAS #87 calculations; however, the levels used for funding and expense would usually not be selected to simulate an annuity purchase. It is would also be possible to adopt the demographic assumptions used for these calculations, but to utilize a Treasury Bond rate (of appropriate duration) as the interest rate. Employee turnover should be used judiciously: it cannot be applied to nonvested benefits, since all benefits would be fully vested on plan termination; however it can be used to determine whether an employee will "grow into" benefit subsidies.
Even more confusion arises because the regulations under IRC 414(l) offer the actuary a set of "safe harbor" assumptions. These assumptions are those used by the PBGC as of the date of spinoff. The problem with this approach is that the PBGC assumptions are quite conservative, do not recognize employee turnover, have been overtaken by changes in law since the 1981 regulation, have been disavowed by the PBGC under a new basis proposed in 1993, and have been in part declared unacceptable by the IRS as a safe harbor.\(^5\)

The PBGC's proposed 1993 basis was, in fact, adopted late in the year; however it applies to only some of the calculations using the original basis. Presumably a spinoff would be a valid use of the 1993 basis, and presumably this basis becomes the new "safe harbor".

\(^5\) The following question was posed to an IRS representative at the 1990 meeting of Enrolled Actuaries; his response follows:

**Question 11:** Regulations section 1.414(1)-1(b)(5), permits the use of "reasonable actuarial assumptions." That section also provides that PBGC assumptions "are deemed reasonable for this purpose."

Does this continue to be the IRS position? For example, if a plan would be sufficient to provide all benefit liabilities if it terminated on the date of a spinoff using PBGC interest, mortality and retirement age assumptions, would an asset transfer to an unrelated company equal to 100% of such benefit liabilities for the transferred employees satisfy 414(1)?

**Response 11:** With one exception, the IRS position regarding actuarial assumptions in a spinoff expressed in regulations section 1.414(1)-1(b)(5) remains unchanged. PBGC interest and mortality assumptions used in combination are still deemed to satisfy the reasonableness requirement; however, the retirement age assumptions used by PBGC should no longer be deemed reasonable.
The plan sponsor is, thus, left with the actuary's professional judgment as the only protection against an illegally large or an illegally small transfer amount. The plan sponsor and actuary can take solace in recent court cases reiterating that there are a range of reasonable assumptions, and not a single precise set. However, the sponsor must recognize that the actuary's duty under ERISA as an Enrolled Actuary is to act in the interests of the plan participants.

**Financial Effect**

Asset transfer amounts are shown on the accompanying table for an April 1993 spinoff from a $100 million Plan. (As interest rates change, the overall dollar amounts will, of course, also change; however the companies remain valid). While not all of the possible asset amounts may be within the actuary's personal range of reasonableness, all of them have been used or considered for recent spinoffs. While the interest discount assumption usually attracts the most attention, it is frequently the retirement age assumption which has the most financial impact and is the most difficult to select.

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(6) In the 1992 US Tax Court decision in Wachtell, Lipton et al v. Commissioner, Judge Clapp stated, "Congress acknowledged that actuaries are not charged with the responsibility of determining a 'correct' set of assumptions, but with the responsibility of determining assumptions that fall within a range of reasonableness."
Other Ticklish Situations

Some of the additional considerations which could influence the selection of assumptions are:

- As assumptions move to the more conservative end of the spectrum, a plan’s surplus can evaporate, and the plan may even become underfunded. (Note that this occurs in Case #1, where the remaining 80% of the participants would be left with only $74 million of assets - an illegal outcome under IRC 414(l) because it leaves the remaining plan unfunded.)

- In times of rapidly changing interest rates, a specific interest rate negotiated in advance of the spinoff may prove to be unacceptable by the actual transfer date.
<table>
<thead>
<tr>
<th>ACTUARIAL ASSUMPTIONS</th>
<th>Mortality</th>
<th>Retirement Age</th>
<th>Interest</th>
<th>Turnover*</th>
<th>Amount ($ Million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. PBGC Original Assumptions</td>
<td>1984 UP</td>
<td>Avg 61</td>
<td>5%-4% graded</td>
<td>No</td>
<td>$26</td>
</tr>
<tr>
<td>(Original Safe Harbor)</td>
<td></td>
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<tr>
<td>2. PBGC 1993 Assumptions</td>
<td>1983 GAM</td>
<td>Avg 61</td>
<td>6.4%-6% select/ultimate</td>
<td>No</td>
<td>$21</td>
</tr>
<tr>
<td>(New Safe Harbor?)</td>
<td></td>
<td></td>
<td></td>
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<td></td>
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<tr>
<td>3. FAS #87 ABO</td>
<td>1983 GAM</td>
<td>Avg 63</td>
<td>9%</td>
<td>Yes</td>
<td>$12</td>
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<tr>
<td>4. IRS Minimum Funding Requirements</td>
<td>1983 GAM</td>
<td>Avg 63</td>
<td>8%</td>
<td>Yes</td>
<td>$14</td>
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<tr>
<td>5. Sample of 6 Sound Annuity Carriers(7):</td>
<td>1983 GAM</td>
<td>Avg 57</td>
<td>6.65%</td>
<td>Yes</td>
<td>$22</td>
</tr>
<tr>
<td>- Early Retirements</td>
<td>1983 GAM</td>
<td>Avg 64</td>
<td>6.65%</td>
<td>Yes</td>
<td>$16</td>
</tr>
<tr>
<td>- Late Retirements</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6. Using Treasury Bond Rate with Demographic Assumptions</td>
<td>1983 GAM</td>
<td>Avg 57</td>
<td>6.95%</td>
<td>Yes</td>
<td>$21</td>
</tr>
<tr>
<td>per #5:</td>
<td>1983 GAM</td>
<td>Avg 64</td>
<td>6.95%</td>
<td>Yes</td>
<td>$15</td>
</tr>
<tr>
<td>- Early Retirements</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Late Retirements</td>
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</tbody>
</table>

(7) Mean of six quotations received each month by the Mercer Insurance Group. The quotations are for small- and medium-size plans and (in the sample above) are for a non-retired group of participants with a Macauley Distribution of 15.0 years. The carriers are those currently very active in the single premium annuity marketplace, and have Claims-Paying Abilities of between AA and AA+. The interest rate is net of expenses and profit margins.
Since the Plan is not actually terminating at the date of spinoff, a structured bond settlement in sometimes proposed as a reasonable proxy for an annuity purchase. This enables interest rates to be more readily determinable.

SFAS #87 requires that the discount rate "track" current annuity or bond markets. However, many Plan sponsors are have used rates which seem to be seriously wide of this standard. Strong pressure by the SEC was exerted in the fall of 1993 to correct this practice, and it has succeeded in narrowing the disparity.

The past history of retirement patterns may differ significantly in the future, due to possible business restructuring, differences in pension plan provisions and retiree medical availability.

Plans with employee contributions or employee entitlements to surplus present serious issues of equity. Underfunded Plans involve a different set of questions; consider, for example, the 1986 Pension Protection Act, which prohibits a plan sponsor from terminating an underfunded plan.

Inexpertly-drafted or confusing sales agreements can cause thunderous disputes on what assumptions were even intended.

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Paragraph 43 of SFAS #87 states: "Assumed discount rates shall reflect the rates at which the pension benefits could be effectively settled. It is appropriate in estimating those rates to look to available information about rates implicit in current prices of annuity contacts that could be used to effect settlement of the obligation (including information about available annuity rates currently published by the Pension Benefit Guaranty Corporation). In making those estimates, employers may also look to rates of return on high-quality fixed-income investments currently available and expected to be available during the period to maturity of the pension benefits."
Avoiding the Actuarial Surprise

Actuaries are subject to increasing scrutiny of their assumptions, prompted by IRS audits, FASB requirements and the growing sophistication of the financial community. Corporate negotiators have found that their actuaries can be valuable allies, if pension issues are discussed frankly and in advance. A creative actuary’s experience can frequently help break through a negotiating impasse. An actuary who is called to the scene too late, however, may bear the bad news that the intended spinoff runs afoul of professional judgment, actuarial standards, and legal compliance.